

CLIENT ALERT

Virtual Currency Update: Increased Government Scrutiny and Enforcement

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Federal and state market regulators are closely scrutinizing the evolution of the virtual currency marketplace, warning investors about the potential for offerings of “unregistered securities” and “get-rich-quick schemes.” The Commodity Futures Trading Commission and the Securities and Exchange Commission have both successfully asserted jurisdiction over this burgeoning marketplace, and have instituted enforcement actions involving fraudulent, unregistered offerings and unregistered exchanges.

Federal District Court: Virtual Currency is a Commodity Subject to CFTC Anti-Fraud Jurisdiction

On March 6, 2018, U.S. District Court Judge Jack B. Weinstein entered a preliminary injunction against the defendants in *Commodity Futures Trading Commission v. Patrick K. McDonnell and CabbageTech, Corp. d/b/a Coin Drop Mkts.*,¹ in which the court held that virtual currency is a commodity under the Commodity Exchange Act (“CEA”).

On January 18, 2018, the Commodity Futures Trading Commission (“CFTC”) filed a complaint against Mr. McDonnell and his company, CabbageTech, Corp. doing business as Coin Drop Markets (“CDM”), alleging that Mr. McDonnell was engaging in fraud. The CFTC complaint asserted that Mr. McDonnell and CDM induced customers to send money and virtual currency to CDM in exchange for virtual currency trading advice and for purchasing and trading virtual currency on behalf of customers under Mr. McDonnell’s direction. The CFTC complaint alleged that the virtual currency advice was

¹ No. 18-CV-361 (E.D.N.Y. Mar. 6, 2018).

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never provided and the funds provided to CDM for purchasing and trading virtual currency were misappropriated. As relief, the CFTC sought restitution to customers, disgorgement of benefits from violations of the CEA and CFTC Regulations, civil penalties and an injunction against future violations of federal commodities laws.

The court granted the CFTC a preliminary injunction against the defendant for future violations of federal commodities laws. In granting the preliminary injunction, the court held that virtual currencies are commodities by deferring to the CFTC's 2015 interpretation that virtual currencies are commodities under the CEA. Because virtual currencies are commodities, the CFTC has enforcement authority over fraud involving spot markets underlying the derivative markets of virtual currency, although it does not have general regulatory authority over the spot markets.

SEC Action on Potentially Unlawful Online Platforms

Separately, on March 7, 2018, the Securities and Exchange Commission ("SEC") issued a public statement cautioning that platforms allowing investors to buy and sell digital assets, which include coins and tokens offered in Initial Coin Offerings ("ICOs"), may be operating unlawfully as unregistered exchanges.² Platforms that offer trading of digital assets that are securities and operate as an exchange under the federal securities laws must register with the SEC or qualify for an exemption from registration. The SEC warned investors that online platforms that do not register properly as exchanges are less protective against fraudulent and manipulative trading practices, and again called attention to "potentially unlawful" activity in the trading of digital tokens.

In its March 7 release, the SEC also stated that online trading platforms that do not meet the definition of an exchange, but directly or indirectly offer trading or other services related to digital assets, may nevertheless be required to register with the SEC as a broker-dealer, transfer agent or clearing agency, among others, depending upon the circumstances. The SEC warned that it will continue to focus on online platforms that offer trading of digital assets to ensure they are in compliance with the federal securities laws.

The statement from the SEC followed an SEC enforcement action against an operator of an online platform that traded digital assets.³ The SEC alleged that the online platform, BitFunder, and its founder, Jon E. Montroll, operated BitFunder as an unregistered online securities exchange and defrauded exchange users by misappropriating their bitcoins and failing to disclose a cyberattack on BitFunder's system that resulted in the theft of more than 6,000 bitcoins. The SEC also alleged that Mr. Montroll sold unregistered securities that purported to be investments in BitFunder and misappropriated funds from that investment as well. In bringing this action, the SEC sought a permanent injunction and disgorgement plus interest and penalties.

² *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets*, SEC Public Statement, Mar. 7, 2018, [available here](#).

³ *SEC Charges Former Bitcoin-Denominated Exchange and Operator With Fraud*, Press Release, Feb. 21, 2018, [available here](#).

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Potential for a Virtual Currency Self-Regulatory Organization

In an additional virtual currency development, Cameron and Tyler Winklevoss, who direct the Gemini exchange, submitted a proposal to the CFTC to create the Virtual Commodity Association, a self-regulatory organization meant to oversee the virtual currency market and custodians. Commissioner Brian Quintenz welcomed the effort and encouraged Gemini or other market participants to work toward forming a self-regulatory organization.⁴

Increased Scrutiny from the States

State regulators are also increasingly active in the ICO marketplace. On March 27, 2018, Massachusetts securities regulators ordered five area firms that purportedly use blockchain technology to immediately stop the offering and selling of “unregistered securities” through ICOs, in a further effort to address fraud in the burgeoning ICO marketplace. Secretary of the Commonwealth William F. Galvin’s office entered into five separate consent orders with Matternest Inc., Pink Ribbon ICO, Across Platforms Inc., Sparkco Inc. and 18moons Inc., ordering each firm to stop offering their coins and to offer rescission to anyone who had already purchased them. It appears that none of the ICOs were ever actually opened. Galvin accused the firms of promoting virtual currency coins that were not registered with his office as required. Galvin noted that the consent orders are the result of an “aggressive sweep” to police the virtual currency market amid the meteoric rise of some virtual currencies.

On February 9, 2018, the New Jersey securities regulator issued an emergency order to stop Bitstrade, an online cryptocurrency-related investment entity, from offering unregistered securities in New Jersey. The order issued by the New Jersey Bureau of Securities found that Bitstrade is violating New Jersey’s Uniform Securities Law by offering investors an unregistered security in the form of an investment pool. The order further states that Bitstrade failed to disclose material facts to prospective investors such as the names of the executive officers, the address of its principal office, information about Bitstrade’s financial condition, the risks of the investment, and how Bitstrade invests investors’ money.⁵ In addressing the order, New Jersey State Attorney General Gurbir S. Grewal noted that “[t]he Bureau’s action... reinforces our commitment to protecting investors as they navigate the uncharted and largely unregulated domain of cryptocurrency-related investments. We want to make sure that investors tempted to cash in on the cryptocurrency rage aren’t being lured into sending funds to an anonymous internet entity without knowing where the funds are going or how they’ll be used.”⁶

⁴ *Statement of CFTC Commissioner Brian Quintenz on a Proposal by Cameron and Tyler Winklevoss for a Virtual Commodity SRO*, March 13, 2018, [available here](#).

⁵ *New Jersey Bureau of Securities Summary Cease and Desist Order* (Feb. 9, 2018) [available here](#).

⁶ The press release from the New Jersey Office of the Attorney General is [available here](#).

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